Chapter 3

Raw milk pricing and supply contracts

3.1 Raw milk pricing is determined by processors as negotiated within the terms of supply contracts entered into with farmers. Each processor has different supply contracts and the price farmers receive depends on a variety of factors—such as, milk quality, volume supplied, timing of volume supplied, and premiums associated with contract length.

3.2 Different supply agreements and contract arrangements are used by processors to meet their needs for raw milk. As such, it can be challenging to compare milk supply agreements and contracts. However, there appears to be a number of common elements in these supply agreements and contracts that contribute to a power imbalance heavily in favour of the processors. Even in regions where there may be multiple processors, farmers can face difficulties moving between processors due to limited processing capacity.

3.3 Industry stakeholders have put forward a range of options to improve farm gate milk price stability and address the power imbalance between processors and suppliers[1], including more equitable sharing of risk. This includes strengthening provisions for collective bargaining, and better understanding the implications of unfair contract term laws for milk supply contracts. In addition, the industry has developed and is commencing the implementation of a code of conduct for best practice in contractual relationships.

How milk prices are set

3.4 Farm gate milk prices are based on the milkfat and protein components of raw milk, with protein attracting a higher price. Processors in the Southern Milk Region typically set prices based on each kilogram of milk solids ($ per kgMS) in milk supplied, while processors in other regions set prices based on litres of production (cents per litre). The quality and composition of milk can vary depending on location, cow breed, age, nutrition and feed quality.

3.5 With approximately 34 per cent of milk production being exported as butter, cheese or milk powder, Australian farm gate milk prices are heavily influenced by global dairy commodity prices and exchange rate movements.[2] According to the Department of Agriculture and Water Resources, up to 75 per cent of Australia's milk production is exposed to world prices for dairy commodities.[3]

3.6 The impact of international dairy markets on farm gate prices was outlined by Lindsay and Ann Jarvis:

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1 In the context of this report, suppliers are farmers that provide milk to a particular processor.

2 Dairy Australia, *Australian Dairy Industry In Focus 2016*, p. 8.

3 Department of Agriculture and Water Resources, *Submission 23*, p. 6.

> Even states that see themselves as domestic marketers are impacted by the greater proportion of imported dairy products being sold under our free market policy.[4]

3.7 Variations in milk prices are also influenced by the ownership structures of the individual processor, the quality and volume of milk, and other contract terms and conditions which may also specify when milk is to be delivered during the year. Milk pricing also varies between processors due to the product mix, marketing strategies, the utilisation and efficiencies in factory processing capacity, and exchange rate hedging policies. Competition for milk among processors may influence milk prices as can the distribution policies of farmer owned co-operatives.[5]

3.8 In relation to farm gate milk prices, Bega Cheese commented that price variations between regions are often driven by three factors:

- the market return derived from the milk;
- the alternative source of milk or dairy ingredient; and
- the sustainability of dairy farming within a particular region.[6]

3.9 Hence, the value attributable to a litre of milk in one market ultimately has the potential to affect the value of a litre of milk in another market. Mr Brett Findlay argued that Murray Goulburn (MG) was the main price setter of the farm gate milk price across eastern Australia:

> Deregulation of the industry has removed barriers to milk movement across state borders so processors, particularly in NSW and Qld, have the option of buying milk wholesale from Victoria instead of buying from local farmers in those regions. For these regions, MG is, by and large, the price setter for farm gate milk price for the dairy industry throughout eastern Australia.[7]

3.10 As noted, farm gate milk prices vary across Australia according to the production region.

- In the southern regions, a 'blended' price incorporates returns from the milk used in manufactured dairy products. The pricing of milk in kgMS terms reflects the compositional content of milk supplied and the importance this has in the manufacturing processes.
- In the northern and western regions, higher farm gate milk prices are paid to ensure year-round supply where production is predominately focused on the domestic milk drinking market.[8]

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4 Lindsay and Ann Jarvis, *Submission 3*, [p. 1].

5 Dairy Australia, *Australian Dairy Industry In Focus 2016*, p. 9

6 Bega Cheese, *Submission 37*, [p. 3].

7 Mr Brett Findlay, *Submission 30*, [p. 3].

8 Department of Agriculture and Water Resources, *Submission 23*, p. 6.

Southern Milk Region

3.11 Farm gate milk pricing in the Southern Milk Region—Victoria, Tasmania, southern NSW and South Australia—reflects the seasonal nature of production and the higher exposure to international markets.

3.12 Most farmers supply milk via standard term contracts. For example, MG reports that 76 per cent of its milk is supplied under Standard Milk Payment Terms and these suppliers are free to leave MG at any time. Fixed term contracts are used for remaining 24 per cent of MG milk suppliers.[9]

3.13 Under standard term contracts, milk pricing is determined at the end of the season but opening and expected final prices are set at the start of the season. Opening prices are typically around 90 per cent of the expected final price. However, a relatively high opening price has the potential to result in a significant retrospective 'step-down'. Adjustments to milk pricing occur across the season as greater certainty of the market returns is realised:

> …farmgate milk prices can be increased or decreased. Price increases are referred to in the industry as "step ups" and are usually paid retrospectively for milk supplied from the beginning of the season. Price decreases are referred to as "step downs" and generally do not require suppliers to repay payments for milk already supplied; rather, the milk price is reduced for milk supplied for the remaining months of the season to achieve a season average.[10]

3.14 Murray Goulburn outlined its strategy in setting the opening price:

> MG typically announce a forecast full year final FMP [farm gate milk price] and then pay 90-92 per cent of the forecast final FMP as the opening price to support supplier cashflows. Traditionally this has been common practice for other Australian processors operating in the Southern Milk Region. The balance of the milk pool is paid to suppliers throughout the year as backdated step-ups…The level of the opening price does come with risk when there is increased volatility in either commodity markets or foreign exchange rates, particularly given MG's exposure to export markets.[11]

3.15 While competition for milk supply is robust, some farm gate milk prices are dependent on the price paid by the 'leading supplier'—Murray Goulburn. For example, Fonterra highlighted that it is required to pay farmers no less than the price paid for that season by the leading Victorian processor by milk volume.[12]

3.16 Standard milk supply contracts generally have the ability for the processor to vary the price paid for milk supplied. This price is then adjusted over the season as

9 Murray Goulburn, *Submission 8*, p. 10.

10 Fonterra Co-operative, *Submission 38*, p. 3.

11 Murray Goulburn, *Submission 8*, p. 8.

12 Fonterra Co-operative, *Submission 38*, p. 3.

market expectations change. The committee notes that while the price reduction in 2015–16 was regrettable (see chapter 5), the retrospective elements of milk contracts were legal:

> The reduction in the opening price was done by MG in compliance with terms and conditions of the milk contract.[13]

3.17 That said, it should be noted that downward price adjustments are rare and, according to MG, this has only happened three times in the last 65 years. In all other years, MG has delivered a final price equal to or in excess of the opening price for suppliers.[14]

3.18 Although not as common as milk supply agreements, some processors have sought to lock-in milk supply and give farmers greater price stability by offering fixed term contracts. For example, Lion Dairy and Drinks has been responsive to farmers looking to reduce price volatility:

> Since 2013, Lion has offered its dairy farmers in the southern region (Victoria, Tasmania and South Australia) a broad range of fixed and variable farm gate pricing options for contracts of varying lengths (one, three or five years) that help farmers to better manage market volatility.[15]

3.19 Fonterra also notes that it 'gives farmers options to manage the risk of step downs by "locking in" a fixed milk price or range':

> Our Fixed Base Milk Price allows suppliers to lock in a volume of milk at a set price, similar to locking in part of a home loan at a fixed interest rate.[16]

3.20 In the case of MG, approximately 40 per cent of its fixed term contracts [approximately 6 per cent of total contracts] arose as a result of supplier participation in MG's capital restructure 'Supplier Share Offer' (see chapter 5). Suppliers were offered discounted MG shares if they signed supply agreements with MG for between one and three years. The remainder of MG's fixed term contracts are part of commercial business arrangements.[17]

Other milk supply regions

3.21 In other milk supply regions—central and northern NSW, southern Queensland and Western Australia—processors generally seek to smooth production across the year to meet domestic fresh milk production. In these regions, processors make greater use of contracts and price signals to encourage flat supply and avoid surpluses, as there is limited capacity to process surpluses into storable dairy

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13 Murray Goulburn, *Submission 8*, p. 22.

14 Murray Goulburn, *Submission 8*, p. 11.

15 Lion Dairy and Drinks, *Submission 13*, p. 2.

16 Fonterra, *Submission to the ACCC Dairy Inquiry*, 12 December 2016, pp. 8–9, https://www.accc.gov.au/system/files/Fonterra%2520Australia%2520Pty%2520Ltd.pdf (accessed 22 July 2017).

17 Murray Goulburn, *Submission 8*, p. 10.

products.[18] Contracts often place constraints on the quantity and timing of milk supply, and pay lower prices for milk supplied outside agreed parameters.

3.22 Farm gate milk prices in these regions are usually higher than in the southern region, reflecting high costs associated with providing a more stable supply and the higher costs of production more generally. Processors are often willing to pay higher prices to balance the lower fresh milk transport costs of local production.

3.23 MG noted that the different pricing structure in the NSW-Sydney Milk Region reflects the use of milk produced in this region as daily pasteurised milk and the associated need to have a consistent year round supply.[19] The Standard Milk Supply Payment Terms also apply to suppliers in the NSW-Sydney Milk Region that are not on fixed contracts; however, suppliers in this region are generally paid a higher rate than MG suppliers in the Southern Milk Region.

3.24 While contract terms and conditions for other processors were not readily available, the committee understands that most terms and conditions are fairy generic and pertinent to the supply of raw milk.[20]

3.25 Not all processors have constraints on the volume of milk supplied. Norco, a cooperative based in northern New South Wales, offers milk suppliers a range of milk supply agreements of up to five years duration. In return for entering into a milk supply agreement, Norco guarantees to pick up all the milk produced on member farms. Norco has invested in manufacturing facilities that enable it to process excess milk not needed for the drinking milk market into value-added ice-cream products.[21]

3.26 Reflecting on the declining volume of milk being produced outside the Southern Milk Region, Mr Andrew Weinert commented that many of the competitiveness issues currently faced by the dairy industry in Western Australia and Queensland were the result of payment systems established before deregulation. The quota payment system discouraged the production of milk in excess of set volumes and, as a result, did not create incentives for investment in manufacturing plant and infrastructure to produce storable dairy products. Following deregulation, processors in these regions were not in a position to compete with more efficient processors either domestically or internationally.[22]

3.27 The Queensland Dairyfarmers' Organisation (QDO) considered that a lack of equity in competition in the market had reduced opportunities for dairy farmers in Queensland, particularly relative to other employment opportunities. This has resulted in a lack of investment on the farm to keep it a viable and sustainable business.[23]

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18 RIRDC, *From Farm to Retail - how food prices are determined in Australia*, p. 67.

19 Murray Goulburn, *Submission 8*, p. 9.

20 Brownes, *Submission 42*, [p. 2].

21 Norco, *Submission 18*, pp. 2–3.

22 Mr Andrew Weinert, *Submission 20*, p. 25.

23 QDO, *Committee Hansard*, 31 January 2017, pp. 3–4.

Alternative fresh drinking milk suppliers

3.28 Some smaller drinking milk operations also explained how they set farm gate prices. Many of these operations are owned by farmers who have taken the initiative to set up their own small-scale milk processing facilities and to sell their milk to independent retail outlets or as part of an integrated supply chain. While taking on more risk, these small-scale processors have been able to increase the farm gate milk price relative to what they might have received from supplying a large processor.

3.29 Harris Farm Markets, a retailer based in New South Wales, explained how they were able to influence the farm gate price for two of the products they stocked:

> We only set the farm gate price for two products that we sell—a small range of pure Jersey milks and an organic private label milk. We pay the farmers at least 80c/L for these milks…This price was directly negotiated with the farmers and we included in the negotiation the ability to review the price once a year or if there was a very significant movement in the cost of producing the product. Part of that discussion was ensuring we established a price that allowed the farmers to produce, maintain quality and invest in their farms for the long term…[24]

3.30 Mr Greg Dennis, who started the 4RealMilk label in southern Queensland, said that a farm gate milk price of 65c/L was paid to farms supplying this brand. This was about 15 per cent a litre more than farmers in that region were getting from large processors.[25]

3.31 As discussed later in chapter 4, both Coles and Woolworths have entered into arrangements that purport to support farmers either directly (in the case of Woolworths) or indirectly (in the case of Coles). While these initiatives provide higher farm gate prices or other assistance, there are only a relatively small number of farmers who can access and benefit from direct supply arrangements for drinking milk. Smaller operations have higher costs structures and are competing in a very competitive market dominated by larger processors and retailers with significantly more market power.[26]

3.32 Fonterra noted in its submission to the ACCC inquiry into the dairy industry that it was firmly of the view that 'competition is intensifying as processors compete for a declining milk pool'. Demonstrating the impact of price competition, Fonterra highlights its milk supply agreement with the Bonlac Supply Company (BSC), where it is required to pay farmers no less than the price paid for that season by the leading Victorian processor (by milk volume), which for the term of the agreement has been Murray Goulburn.[27] That said, Fonterra announced in July 2017 that it is seeking to

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24 Harris Farm Markets, *Submission 1*, [p. 1].

25 Mr Greg Dennis, *Committee Hansard*, 15 November 2016, p. 37.

26 Mr Greg Dennis, *Committee Hansard*, 15 November 2016, pp. 35–36.

27 Fonterra, *Submission to the ACCC Dairy Inquiry*, 12 December 2016, pp. 1–3, https://www.accc.gov.au/system/files/Fonterra%2520Australia%2520Pty%2520Ltd.pdf (accessed 22 July 2017).

transition away from the Bonlac Supply Agreement and move to a new agreement with better farmer input and governance.[28]

Issues with current contracting practices

3.33 Contracting practices in the dairy industry have been raised as an ongoing issue in the many and various examinations of the industry undertaken since deregulation. Farmers consistently highlight the power imbalance between processors and suppliers as an important factor in the viability and sustainability of the dairy industry in Australia.

3.34 The Australian Small Business and Family Enterprise Ombudsman (ASBFEO) considered there to be three broad issues of critical importance:

- a lack of clarity and certainty around price within supplier agreements and contracts, resulting in risks being borne by those least able to manage the risks (especially retrospective changes);
- a lack of price signalling that is visible and communicated across the industry so that trends and opportunities are unclear and not understood; and
- contracting practices are poor with contracts not being openly negotiated and lacking flexibility and transparency.[29]

3.35 Numerous stakeholders expressed concerns about milk supply arrangements and farm gate milk price setting. Farmer Power neatly summarised what it saw as the problem with the current contracting system:

> A contract is normally understood to be something that spells out two way rights and responsibilities. Most of the milk supply contracts fail to meet this test, as they give processors all the rights and farmers all the responsibilities.[30]

3.36 Similarly, Dairy Connect noted that:

> …the decision by retailers to sell milk at such a low cost…may be considered a symptom of the current dairy crisis rather than a cause. It is…the low cost of the farm-gate price that is paid to dairy farmers that is of most concern and this relates to the current terms and conditions contained in milk supply agreements between dairy producers and processors.[31]

3.37 Australian Dairy Farmers emphasised transparency and fairness in contracts as high priorities for farmers to restore confidence.[32] Similarly, DairyTas commented

28 Clint Jasper and Warwick Long, Fonterra raises milk prices, moves to scrap Bonlac supply agreement, *ABC News Online*, http://www.abc.net.au/news/rural/2017-07-28/fonterra-scraps-bonlac-agreement/8752040 (accessed 31 July 2017).

29 ASBFEO, *Submission 2*, [p. 2].

30 Farmer Power, *Submission 17*, p. 6.

31 Dairy Connect, *Submission 40*, [p. 2].

32 Mr John McQueen, Australian Dairy Farmers, *Committee Hansard*, 2 February 2017, p. 39.

that 'there needs to be improvement in contracting arrangements with dairy farmers to give them better certainty and security'.[33]

3.38 More generally, Mr John Cochrane considered that:

> We definitely need to get the balance of power back to the people that are producing. We produce a quality product. It must go every 24 hours, so there is a huge case to give the farmers the balance of power.[34]

3.39 Indeed, the perishable nature of raw milk production means farmers require terms and conditions in contracts that rebalance power between themselves and processors.

Pricing clarity and certainty

3.40 For many farmers, improving pricing clarity and certainty within milk supply contracts is central to levelling the power balance and facilitating more risk sharing between processors and suppliers. The ASBFEO highlighted the importance of better sharing risk across the supply chain through:

- contracts setting out a clear price, pricing mechanism and/or price notification processes (including appropriate notification and transparency in retrospective price step-downs); and
- appropriate sharing of risk by those most able to manage the risk (including through hedging by processors and/or improved contracting practices).[35]

3.41 Some farmers highlighted the difficulties of running a dairy farm with variable pricing. Mr Rhys Palmer commented that:

> Just looking at it from a farmer's point of view, the fluctuation in pricing causes a lot of grief. It goes from low to high in one year, and it is very difficult to run a business under those conditions. I just wonder whether there is some way—and I know it is very difficult—that we can have the price on a more level basis.[36]

3.42 Similarly, Ms Penny Williams suggested that:

> … the biggest thing that would help the dairy industry is if we just knew that we were going to receive a price that could cover all the costs year in and year out.[37]

3.43 Some processors have sought to better balance the pricing risk with farmers. For example, in 2013, Lion Dairy and Drinks (Lion) responded to farmer concerns about managing volatility in the milk price in the Southern Milk Region by offering

33 Mr Mark Smith, DairyTas, *Committee Hansard*, 3 February 2017, p. 40.

34 Mr John Cochrane, Premium Milk Collective Bargaining Group, *Committee Hansard*, 31 January 2017, p. 20.

35 ASBFEO, *Submission 2*, [p. 2].

36 Mr Rhys Palmer, *Committee Hansard*, 3 February 2017, p. 2.

37 Ms Penny Williams, *Committee Hansard*, 3 February 2017, p. 3.

fixed price contracts for three years to lock in a price for 50 per cent of milk production. This approach has provided some farm gate milk price stability while still allowing farmers to benefit when prices are high, but effectively providing a floor price when prices are low:

> …by locking in only 50 per cent we can manage it together. If it were 100 per cent, what would happen is we might lock in pricing, but then if the market moves the farmers will all detest that our price is not competitive enough. The flipside is that, if I locked in 100 per cent and then all my competitors had an advantage, there would be a new managing director appearing in front of you because it would have been such a bad decision. So at 50 per cent we can hold hands together and manage the risk.[38]

3.44 Lion also relayed their experience in having a pricing approach that differentiates between milk that is used for private label products and milk that is processed for branded products:

> In the past, Lion has experimented with a two-tier pricing structure of this kind which reflected the return Lion could secure for its product. This proved unpopular with farmers as returns on highly commoditised products were very low. In practice, if this approach was applied to sales of private label and branded milk, such an approach would only be beneficial to farmers if the long term decline in branded milk market share is reversed…[39]

3.45 Some stakeholders were concerned about the appropriateness and application of retrospective price changes, both up and down, for milk supplied throughout a season. As retrospective price reductions have been implemented twice in the last decade, there would appear to be issues in the opening price setting mechanism. Strong competition for milk in the Southern Milk Region has seen opening prices set at levels that may not realistically account for lower market prices across the year.

3.46 Bega Cheese highlighted the faith that many farmers place in processors where the farm gate milk price can vary throughout the year:

> …the dairy farmer would expect that the processor with their knowledge of the market would deliver an opening price that was appropriately conservative and has the potential to be improved upon or at least remain flat. They would not expect that the price may be reduced.[40]

3.47 Fonterra highlighted the importance of transparency for the milk pricing system to work effectively:

> For this milk pricing system to function successfully across the industry and be sustainable, it is very important that processors provide transparent and

38 Mr Peter West, Lion Dairy and Drinks, *Committee Hansard*, 3 February 2017, p. 32.

39 Lion Dairy and Drinks, *Submission 13*, p. 6.

40 Bega Cheese, *Submission 37*, [p. 5].

timely price forecasting so farmers can do their income and business planning.[41]

3.48 Given the privileged position of processors in understanding their own operating environment, there would appear to be an onus on processors to communicate clearly and regularly with suppliers signalling prospective price reductions as early as practicable. That said, setting more conservative opening milk prices may also hopefully reduce the need for, and incidence of, retrospective price step-downs.

3.49 Further, there is recognition within the dairy industry that better price signals are required. Noting this, the government has set aside funding in the 2017–18 budget to develop a dairy commodity index to assist in the communication of trends and facilitate business decision making. The ASBFEO advocated for this work to be extended to also assist farmers to understand and apply that pricing information.[42] Consideration of the proposed commodity milk price index is undertaken in chapter 6.

3.50 The committee also heard evidence from farmers that retrospective price step-ups were not paid to farmers who had changed processors part way through the season.[43] Their argument was that the price for milk delivered by parties under the same supply terms should be pro-rata, the same regardless of whether suppliers have switched processors. Fair contracting principles should ensure that retrospective price increases are paid to all farmers regardless of the whether they supplied for the whole year or just part of it.

Contract terms and conditions

3.51 Contract terms and conditions were another issue that was raised regularly by stakeholders. The ASBFEO emphasised the need for contracts to be redrafted to ensure that they are clear, realistic and clearly understood. In addition, the ASBFEO considered the following issues with current contracts should be addressed:

- the ability for processors to unilaterally terminate milk collections and processing;
- loyalty payments operating in a way so as to unnecessarily lock-in farmers to a particular processor;
- volume and exclusivity arrangements limiting farmer ability to sell excess milk to other processors;
- unreasonable notice of termination periods; and
- lack of notice, transparency and negotiation of contract variations.[44]

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41 Fonterra Co-operative Group, *Submission 38*, p. 3.

42 ASBFEO, *Submission 2*, [p. 2].

43 Ms Bridget Goulding and Mr Paul Weller, *Committee Hansard*, 2 February 2017, pp. 9–10.

44 ASBFEO, *Submission 2*, [p. 3].

3.52 Similarly, Dairy Connect considered that the anti-facilitative nature of milk supply contracts remains a barrier to established market principles. Dairy Connect cited exclusivity clauses as creating a heavily one-sided power bias in favour of processors as well as uncertainty in milk prices and contract length as issues that needed to be addressed.[45]

3.53 Dairy Connect highlighted the predicament faced by many dairy farmers:

> Basically a farmer is put in a position where the field officer comes along and says, 'If you don't sign this agreement, you're not going to have a home for your milk.' So the farmer is in a weak position. You cannot really go out and say you are going to sell to somebody else.
>
> The other side of it is that basically there has been a reverse cartel situation working within the industry, where, once you have been so-called signed up with one processor, basically you are not allowed to talk to the other processors and negotiate a better price or a better deal whilst that so-called agreement is in place.[46]

3.54 Farmer Power were critical of the behaviour of some processors that would appear to be taking advantage of their position:

> In applying unfair contract provisions, processors have been found to be threatening farmers who complain or otherwise cause problems. Farmer Power has had reports from farmers about threats to reject milk on falsified claims of contamination, failure to collect milk, reduce the price paid, or even put into effect repossession of the farm.[47]

3.55 Farmer Power also cited a range of restrictions on farmers in milk supply contracts that they consider 'rob them of their collective bargaining ability'[48]:

> At present contracts contain anti-competitive components which take money off farmers without justification. Farmers earnings eroded by "loyalty provisions" (withheld payments), "penalty provisions" (effectively fines for not being able to supply milk due to circumstances beyond the farmer's control), "loan repayments" (including capital and interest deduction from milk payments, even when no loan has been agreed to, or under undisclosed conditions of loans) and "privacy" requirements (preventing disclosure of what or how farmers are being paid).[49]

3.56 Dairy Connect noted that there were concerns about milk testing:

> …farm gate milk prices are based on compositional (fat and protein content) and safety and quality parameters such as somatic cells and microbiological tests. These tests are conducted or arranged by processors and dairy farmers have expressed concern about the consistency and

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45 Dairy Connect, *Submission 40*, [p. 2].

46 Mr Graham Forbes, Dairy Connect, *Committee Hansard*, p. 11.

47 Farmer Power, *Submission 17*, p. 6.

48 Farmer Power, *Submission 17*, p. 5.

49 Farmer Power, *Supplementary Submission 17.1*, p. 5.

> reliability of these tests and how processors manage the milk payments based on test results. Such tests should be conducted in a manner that ensures consistency, openness and transparency.[50]

3.57 WA Farmers argued for fairer termination periods to be embedded in contracts:

> We believe unreasonable termination periods for dairy farmers by one processor are unacceptable. We believe 3 months is a fairer termination period for both dairy farmers and processors alike. WA dairy farmers don't have the luxury of picking up another contract given the limited access to the number of processors operating in WA.[51]

3.58 Even when reasonable termination notice was given, a lack of competition among processors in some regions created difficulties for farmers seeking to find a home for their milk. Former dairy farmers from Western Australia told the committee of how Brownes Foods effectively forced them from the industry by not choosing to renew their supply contract, even when they were willing to take a much lower farm gate milk price.[52]

3.59 Similarly, the QDO raised concerns about the ability of dairy farmers to switch between processors:

> The issue with offsetting contracts is that they do not all come at the same time. So, for some farmers, even when they might have a couple of options, the options are not really there because if they come off contract as of 30 June and the other processor is not coming on contract until 1 January there is a hiatus…In domestic marketplaces like Queensland, the options for those farmers to…play the market simply do not exist.[53]

3.60 In consultation with farmers, it was apparent that there was some misunderstanding of the terms and conditions within contracts. For example, many of the farmers that signed up to the MG Supplier Share Offer (SSO) did not appear to realise that they were locking in their production to MG for a fixed period. In regards to the SSO process, Mrs Sarah Parker noted that:

> …at the time that that contract was delivered, by the time you did your farm rolls and tried to find legal support or legal advice, the time was so short that to find a particular lawyer who understands milk contracts, for example, as a specialist field almost, you do not have a lot of time to do that.[54]

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50 Dairy Connect, *Submission 40*, [p. 3].

51 WA Farmers, *Submission 46*, p. 4.

52 Mr Graham Manning and Mr Dale Hanks, *Committee Hansard*, 1 February 2017, pp. 8–10.

53 Queensland Dairyfarmers' Organisation, *Committee Hansard*, 31 January 2017, p. 3

54 Mrs Sarah Parker, *Committee Hansard*, 2 February 2017, p. 21

3.61 Mr Ben Govett commented that he thought 'farmers definitely need better advocacy at a legal level to work through these contracts and know exactly where they stand'.[55] This position was supported by Mrs Parker:

> When a farmer is offered a contract, he needs to be told—because not everybody has the time or the energy or is thinking—'You need to get legal advice about this.' There is nothing wrong with saying that to somebody before they sign something.[56]

3.62 There appear to be limited services provided by dairy farmer advocates to assist farmers understand milk supply contracts and their legal and financial ramifications. Mr Ben Govett commented that:

> Immediately after this happened I was involved in a meeting with our advocacy bodies. One of the things we asked for was for someone with legal knowledge to go through the contracts and see about the legalities, and go through the claw-back scheme and loans for the claw-back. We were told that would happen…but talking to Murray Goulburn suppliers and other Murray Goulburn suppliers who were not at that little meeting, they seem to have no further information after being told by the advocacy bodies that they would get a legal team to look at it. It may have happened, but I am unaware of any major developments. Obviously, these guys have not heard anything about this.[57]

3.63 Improving transparency by removing secrecy provisions in contracts was also raised as an issue:

> …there is no doubt that in our industry contracts have been signed under confidentiality agreements, even within companies. That has caused a fair bit of a rift between people coming forward, even to the ACCC, to hand over their information, because they have supplied a company, then they have moved and their neighbour has supplied that company for 20 years but they have signed up to a better deal…To get rid of the secrecy in the pricing structures would be really good.[58]

3.64 A number of the issues relating to contract terms and conditions have been addressed in the code of conduct for contractual relationships (see below). However, other issues, such as improving supplier understanding of contractual terms, may be appropriately addressed by farmer representative bodies and/or the ASBFEO.

Opportunities for collective bargaining

3.65 Some stakeholders advocated for improvements to the ability of dairy farmers to form collective bargaining groups, and for these groups to engage with processors to determine supply contracts.

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55 Mr Ben Govett, *Committee Hansard*, 2 February 2017, p. 18.

56 Mrs Sarah Parker, *Committee Hansard*, 2 February 2017, p. 23.

57 Mr Ben Govett, *Committee Hansard*, 2 February 2017, p. 21.

58 Mr Adam Jenkins, United Dairyfarmers' of Victoria, *Committee Hansard*, 2 February 2017, p. 43.

3.66 In the dairy industry, collective bargaining is when two or more dairy farmers collectively negotiate terms and conditions of supply with milk buyers. However, collective bargaining risks breaching the *Competition and Consumer Act 2010* (CCA Act). That said, collective bargaining has the potential to encourage vigorous competition because it can address power imbalances between farmers and processors. While ACCC approval provides protection from legal action under CCA Act, approval is not automatic, and the ACCC assesses each application to decide if the public benefits outweigh the detriment to the industry.[59]

3.67 Australian Dairy Farmers explained that there have been circumstances where collective bargaining has brought beneficial results:

> South Australia had always had manufacturing milk somewhere about 10 to 15 per cent below the Victorian price. That particular collective bargaining group went and talked to a Victorian company and said: 'Please come and pick us up. We've got about 65 million litres.' That happened, and they got paid the Victorian manufacturing milk price. Within a week, for every dairy farmer in South Australia the manufacturing milk price was the Victorian milk price, and it has basically stayed the same since. So sometimes they can be so successful that they are not needed any longer.[60]

3.68 That said, some farmers saw potential with the collective bargaining model. Mrs Parker commented that:

> The one thing that is positive about collective bargaining is that you have a milk volume that is greater than in individual bargaining. What it does is that it places some of the power—not a lot—in the farmers' hands, because they have a greater pool of milk to negotiate with, which means that potentially, for a milk company, they are negotiating with one representative rather than maybe 10 or 15 individual groups.[61]

3.69 However, Dairy Connect explained the problems with current collective bargaining arrangements:

> The processors do not have to engage with a collective bargaining group if they do not wish to. Whilst we, as farmers, can go through the whole process of joining a collective bargaining group and go through all the hoops, at the end of the day you can quite often get a letter back saying that they do not recognise your collective bargaining group…We have seen in New South Wales that it has been very hard for collective bargaining groups to continue long term.[62]

3.70 Indeed, Australian Dairy Farmers noted that it may be difficult to strengthen the collective bargaining process:

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59 Dairy Australia, *Collective Bargaining for Dairy Farmers*, June 2014, p. 3.

60 Mr John McQueen, Australian Dairy Farmers, *Committee Hansard*, 2 February 2017, p. 36.

61 Mr Sarah Parker, *Committee Hansard*, 2 February 2017, p. 19.

62 Dairy Connect, *Committee Hansard*, 31 January 2017, p. 11.

> We cannot force a company to negotiate with a collective bargaining group. That would be in breach of our authorisation. It is a right of a company to decide who it wants to negotiate with. The provisions that are there now are quite strong, but it is a challenge at times to get people to negotiate.[63]

3.71 The United Dairyfarmers' of Victoria (UDV) reflected on why collective bargaining was not prevalent in Victoria:

> It has not had a place in the Victorian milk industry to this point. I think perhaps the reason for that is the farm gate competition for milk. I think Barry Irvin talked about seven or eight different people hunting for milk in northern Victoria at the moment—the sense that a farmer can provide their milk to a number of different companies has given them the sense that they have a certain control in the process that perhaps the northern or western dairy farmers do not have, which is why they are looking for collective bargaining agreements.[64]

3.72 Australian Dairy Farmers also saw that the costs of arbitration for smaller collective bargaining groups were an issue.[65] For example, the Premium Milk Collective Bargaining Group (PMCBG), representing 193 farmers in the south-east region of Queensland and northern New South Wales, noted that their collective bargaining agreement with Parmalat had broken down after 17 years of operation. The PMCBG contended that there had been a fundamental shift in attitude by Parmalat to using the collective bargaining process to reach a sustainable and predictable outcome for farmers. Of most concern to the PMCBG was the proposed removal of minimum price guarantees and associated uncertainty in farm gate milk prices over the term of the contract. This dispute has been taken to arbitration and is anticipated to cost the PMCBG an estimated $40 000 in external costs.[66]

Code of best practice in contractual relationships

3.73 A code of best practice for contractual relationships has been mooted several times over the last decade. Following the industry upheaval of May 2016, Australian Dairy Farmers released a discussion paper outlining a set of principles which industry could consider in working together to develop a Code of Best Practice on Contractual Relationships. These principles were discussed by farmers and processors in October 2016, and a small working party was formed to further progress the issues raised with a view to developing a draft code of conduct for further consideration by the wider group.[67]

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63 Mr John McQueen, Australian Dairy Farmers, *Committee Hansard*, 2 February 2017, p. 36.

64 Mr Adam Jenkins, United Dairyfarmers' of Victoria, *Committee Hansard*, 2 February 2017, p. 44.

65 Mr John McQueen, Australian Dairy Farmers, *Committee Hansard*, 2 February 2017, p. 37.

66 Mr John Cochrane, Premium Milk Collective Bargaining Group, *Committee Hansard*, 31 January 2017, pp. 16–23.

67 Australian Dairy Farmers, *Submission 10*, [pp. 3–4].

3.74 The Department of Agriculture and Water Resources noted that as a result of the meeting between farmers and processors:

> …milk processors have agreed to the development of a code of conduct with dairy farmers to ensure more transparent and less ambiguous contracts.[68]

3.75 The fundamental principles that the code addresses include:

- pricing adjustments to farmers who are out of contract being clearly defined in the contract and how this might happen;
- how price changes should be made;
- no price changes should be made retrospectively;
- all farmers should receive payment at the time it is accrued over the contract—that is, loyalty payments should not apply to milk previously supplied;
- the pricing formula and the price setting mechanism are clearly defined with the contract;
- exclusivity clauses should not apply if the processor is not prepared to pay the same price for the last litre of milk as the first litre; and
- clearly defined mechanisms for how contract terms and conditions can be modified.[69]

3.76 Australian Dairy Farmers noted that they had attempted to put in the draft code that step-downs should not occur, but this was resisted by processors which cited directors' fiduciary responsibilities in times of crisis.[70] Arguably, more conservative opening prices and more equitable risk sharing arrangements could alleviate the need for retrospective price step-downs, and give more price stability and certainty for farmers.

3.77 Australian Dairy Farmers explained their approach to developing industry buy-in for the code:

> Our objective is to have everybody signed up here and if we have everybody signed up we have a capacity to manage it into the future, collectively again. A mandatory code sits within the ACCC and then the industry tends to be not the keeper of it; the ACCC is the keeper of it. That in itself can be a challenge in this space. So I reiterate that, if we have everybody on board, we are in a good space.[71]

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68 Department of Agriculture and Water Resources, *Submission 23*, p. 2.

69 Mr John McQueen, Australian Dairy Farmers, *Committee Hansard*, 2 February 2017, pp. 35–36.

70 Mr John McQueen, Australian Dairy Farmers, *Committee Hansard*, 2 February 2017, pp. 35–36.

71 Mr John McQueen, Australian Dairy Farmers, *Committee Hansard*, 2 February 2017, p. 38.

3.78 In relation to a code of best practice, the ASBFEO noted that:

> Our overall position is that industry issues are best addressed, wherever possible, by the participants in the industry. This approach should ensure a solution that is fit-for-purpose, is "owned" by the industry, and is focused on developing and growing the industry to remain competitive in international markets.[72]

3.79 Support for the introduction of a code was widespread but not universal, and there was considerable debate about whether the code should be voluntary or mandatory.

3.80 Parmalat Australia agreed that a code of conduct between processors and farmers would be beneficial:

> Competition remains an important mechanism to drive innovation and reward success. However, farmers locked into long term agreements with a processor with little or no price commitment or certainty is not enabling competition. A code of conduct for farmer/processor contracts or at the very least an industry agreed standard contract template, is overdue and would go a long way to restoring farmers confidence that they are being treated fairly.[73]

3.81 Parmalat Australia also considered that:

> Common and widely adopted and agreed industry standards for farmer supply agreements that reflect a genuinely fair and appropriate sharing of market risk would re-build confidence and trust between producers and processors.[74]

3.82 The UDV supported the development of a voluntary code and considered that the development of a Code of Best Practice on Contractual Relationships is key to the way forward for the industry.[75] Similarly, Dairy Connect hoped that:

> …a voluntary code would provide the mechanism for price and volume certainty; that it would provide a way for collective bargaining to operate; and that it would ensure that a way could be provided for the farmgate price to be at a level that would allow them to pay their bills and be above the cost of production.[76]

3.83 Dairy Connect noted that the UK introduced a voluntary *Dairy Industry Code of Best Practice on Contractual Relationships* in 2012, and supported the introduction of a similar code in Australia as an invaluable tool for setting out protocols and ethical practices for all parties along the supply chain, particularly in challenges market conditions:

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72 ASBFEO, *Submission 2*, [p. 1].

73 Parmalat Australia, *Submission 16*, p. 5.

74 Parmalat Australia, *Submission 16*, p. 5.

75 United Dairyfarmers' of Victoria, *Submission 39*, [p. 4].

76 Mr Shaughn Morgan, Dairy Connect, *Committee Hansard*, 31 January 2017, p. 13.

> …the Code acknowledges that a downturn in milk prices is almost always due to volatility in global markets, so in response there should be greater local promotion of dairy produce as well as better facilitated export channels.[77]

3.84 Dairy Connect elaborated on this at the Brisbane hearing saying that they have:

> …been advocating for quite some time the Dairy UK model in terms of a voluntary code. We have indicated previously that we believe that code provides price and volume certainty—something that farmers throughout Australia require. It also has provisions in relation to collective bargaining that provide a mechanism by which they can come together and provide an output that can give a good outcome.[78]

3.85 However, Mr John Cochrane was wary of the effectiveness of a voluntary code:

> I am not so sure people voluntarily want to give up money, so we need to look at the terms. I think at this stage I support a mandatory one.[79]

3.86 Many stakeholders supported the introduction of a mandatory code of conduct. The QDO citied the UK experience where a voluntary code was replaced with a mandatory one:

> Having a mandatory code of conduct I think is really important, and in Britain we have seen that they had a voluntary code of conduct for some time and then had to go into a mandatory form of a code of conduct because it simply didn't work—the voluntary one was not sufficient.[80]

3.87 Farmer Power was critical of the slow progress in developing a code of conduct in Australia given that idea was first raised in 2011.[81] They supported the introduction of a mandatory code of conduct:

> A longer term solution [to the dairy crisis] would be to introduce a mandatory code of conduct that requires fair treatment of dairy farmers by processors. This would include introduction of fair two-way contracts, establishing transparency in pricing of milk, benchmarking price to agreed market indicators, and providing for affordable and fast dispute resolution/compensation mechanisms.[82]

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77 Dairy Connect, *Submission 40*, [p. 3].

78 Mr Shaughn Morgan, Dairy Connect, *Committee Hansard*, 31 January 2017, p. 11.

79 Mr John Cochrane, Premium Milk Collective Bargaining Group, *Committee Hansard*, 31 January 2017, p. 19.

80 QDO, *Committee Hansard*, 31 January 2017, p. 4.

81 Mr Alex Robertson, Farmer Power, *Committee Hansard*, 26 October 2016, p. 18.

82 Farmer Power, *Submission 17*, pp. 9–10.

3.88 At the hearing on 2 February 2017, Mr John McQueen relayed how stakeholder engagement to develop the code had changed with the legislating of unfair contracts legislation:

> So in about a four-month period, there has been an enormous amount of goodwill developed here to progress that—for something that people did not think was necessary; particularly the processors did not think it was necessary. But once it became clear to them that, from 12 November last year, the new unfair contracts legislation was going to apply, and they became aware that it would apply to them—because they did not think it would apply to them—as soon as they realised that, it really was a serious discussion.[83]

The implications of the introduction of unfair contract legislation are considered in chapter 6.

3.89 The committee notes that a *Code of Practice for Contractual Arrangements between Dairy Farmers and Processors in Australia* was released on 30 June 2017. The voluntary code reflects an agreed positon between Australian Dairy Farmers Limited, the Australian Dairy Products Federation and the dairy processors that are signatories (which include the five largest dairy processors). The code is designed to set out the recommended minimum good practice standards in terms of milk supply contracts. A copy of the code is available at Appendix 3.

Avenues to resolve disputes

3.90 In addition to improving terms and conditions and providing more pricing clarity and certainty, there appear to be limited low cost avenues to resolve disputes around milk supply without resorting to legal engagement. Even in collective bargaining disputes, the costs of going through arbitration seem high for groups that operate with limited budgets.

3.91 The introduction of the code of conduct for contractual relationships, together with the oversight provided by unfair contract term legislation, may provide the necessary incentives for processors to include clauses for dispute resolution into milk supply contracts and agreements. The ASBFEO supported the introduction of clear dispute resolution clauses into all supply agreements to facilitate dealing with issues in an efficient, timely and low-cost manner.[84]

3.92 That said, Dairy Connect saw value in having an ombudsman to assist both with contract negotiations and in resolving disputes once contracts had been signed:

> At the moment as individual farmers you have no opportunity, other than to go through a fairly lengthy legal battle with processors, to get changes in those agreements, and also to have those agreements ratified, that they are legally correct. Secondly, if there were disputes on those agreements or

83 Mr John McQueen, Australian Dairy Farmers, *Committee Hansard*, 2 February 2017, pp. 40–41.

84 ASBFEO, *Submission 2*, [p. 3].

> contracts, farmers would have a body they could go to without having to go into extreme legal costs and a legal battle.[85]

3.93 Following the release of the code of best practice for contractual relationships, the ASBEFO, Ms Kate Carnell, indicated that she will monitor its effectiveness over the next 12 months to make sure it is working as intended.[86]

Committee view

3.94 The committee notes that its 2010 report into competition and pricing in the dairy industry revealed that processors have all the market power in the short term (as it is not possible to 'turn off the cows') and the majority of the market power in the medium term (due to limited competition within regions).[87] Without some type of radical intervention, it is unlikely that this power imbalance will be altered. Indeed, there has been limited progress towards any type of reform of contracting practices within the industry as a whole, and only with the retrospective price cuts of May 2016 was a draft code of conduct progressed and formal discussions commenced with urgency.

3.95 The committee welcomes the release of the industry-led, voluntary code of conduct. However, as the code is in its early stages of implementation, it is not yet apparent the extent to which it will change contracting practices within the industry. The committee remains concerned that a voluntary code may not be sufficient to bring about widespread change in milk supply arrangements and contracting practices.

3.96 The committee is disappointed that the code still gives producers the opportunity to impose retrospective price reductions on suppliers. It considers that processors should bear the risk for setting relatively high opening prices and this should be reflected in the code.

3.97 The committee believes that farmer advocacy bodies have an important role in assisting dairy farmers to understand milk supply contracts and their associated legal and financial obligations. To this end, the committee encourages these organisations to consider how they can meet the needs of their members by offering such services.

3.98 The committee considers that collective bargaining in the dairy industry can play a role, in conjunction with other measures, to strengthen the power of farmers in negotiating milk prices and terms with processors. There would appear to be opportunities to improve collective bargaining provisions, particularly around the engagement of processors with collective bargaining groups, in the development of the code of conduct in contractual relationships.

3.99 While the committee notes that the code encourages processors to negotiate with recognised farmer collective bargaining groups, it is disappointed that the code

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85 Mr Graham Forbes, Dairy Connect, *Committee Hansard*, 31 January 2017, pp. 14–15.

86 ASBFEO, *Dairy Code of Practice welcomed*, 3 July 2017, http://www.asbfeo.gov.au/news/news-articles/dairy-code-practice-welcomed (accessed 4 August 2017).

87 Senate Economics References Committee, *Milking it for all it's worth—competition and pricing in the Australian dairy industry*, May 2010, pp. 32–33.

does not include provisions to strengthen collective bargaining arrangements which have the potential to address the power imbalance between farmers and processors.

3.100 The committee considers that ombudsman services have the potential to be more active in supporting farmers to resolve disputes regarding milk supply contracts and welcomes the ASBFEO's interest in the dairy industry.

3.101 While provisions have been made for the voluntary code to be reviewed after the first year and then regularly every three years, the committee believes that this review should be conducted by an independent party that can objectively assess whether the code is working as intended and consider if a mandatory code would be more appropriate.

Recommendation 1

3.102 The committee recommends that the Australian Competition and Consumer Commission (ACCC), as part of its inquiry into the Australian dairy industry, evaluate the extent to which the code of conduct will reduce power imbalances between farmers and processors, and recommend improvements to the code may better achieve this outcome. Any outcomes from the ACCC inquiry should be incorporated in the proposed review of the code after its first year of operation.

Recommendation 2

3.103 The committee recommends that the ACCC consider how collective bargaining in the dairy industry could be strengthened to enable these provisions to be more widely used and assist in addressing the power imbalance.

Recommendation 3

3.104 The committee recommends that any review of the code of conduct for contractual relationships should be undertaken by an independent party that can objectively assess whether the code is working as intended and consider if a mandatory code would be more appropriate.